

ANALYSIS OF ORIGINAL BILL

Author: Wayne

Analyst: Jeff Garnier

Bill Number: AB 305

Related Bills: AB 230 (97/98)

Telephone: 845-5322

Introduced Date: 02-14-97

Attorney: Doug Bramhall

Sponsor:

SUBJECT: Business Expense Deduction/Self-Employed Health Insurance/100% of Amount Paid

SUMMARY

Under the Personal Income Tax Law (PITL), this bill would increase the existing deduction of 25% of a self-employed individual's cost for health insurance to 100% of the amount paid.

EFFECTIVE DATE

This bill would become effective for taxable years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Existing Federal law, after the enactment of the Health Insurance Portability and Accountability Act (HIPAA) of 1996 (P.L. 104-191), provides for a deduction in determining adjusted gross income (AGI) of 40% (effective for 1997) of a self-employed individual's cost for health insurance. Federal law also incrementally allows the deductible percentage to increase to 80% beginning in the year 2006. The percent is increased for taxable years beginning on or after January 1, 1998 as follows: 1998 through 2002 - 45%; 2003 - 50%; 2004 - 60%; 2005 - 70%; 2006 and thereafter - 80%.

Existing state law provides for a deduction in determining AGI of 25% of a self-employed individual's cost for health insurance. The deduction is only allowable as long as a federal health insurance deduction remains in effect.

Under both federal and state law, the cost of health insurance incurred by a self-employed individual that is not deductible in determining AGI may be taken as an itemized medical deduction. Itemized medical deductions are limited to the amount that exceeds 7.5% of the taxpayer's AGI.

Additionally, **under both** federal and state law, health insurance costs include premiums paid for health insurance of the taxpayer, taxpayer's spouse and

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Department Director Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___ X ___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

Date
Gerald H. Goldberg 3/19/97

Agency Secretary

Date

By:

Date:

dependents. The deduction is limited to the extent of the individual's federal earned income from the business from which the health coverage was established. A deduction is not allowed if the taxpayer or taxpayer's spouse is eligible to participate in any subsidized health plan of any employer of the taxpayer or taxpayer's spouse. In addition, under federal law premiums for long-term care insurance are deductible as a medical expense.

This bill would increase the deductible percentage of a self-employed's health insurance cost to 100% of the amount paid or incurred.

Policy Considerations

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. Conformity also eases the Franchise Tax Board's administration of the law by utilizing federal forms and instructions. This bill would not conform state law to federal law.

This bill would allow self-employed individuals to fully deduct medical premiums, whereas wage earners who purchase their own health insurance can deduct only the amount that exceeds 7.5% of AGI. However, health insurance paid by an employer is fully excludable from income for the employee and is fully deductible by the employer as a business expense.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

FISCAL IMPACT

Departmental Costs

Insignificant departmental costs would be incurred implementing the bill.

Tax Revenue Estimate

The revenue losses from this provision are estimated to be as shown in the following table.

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 1996 Enactment Assumed After June 30, 1997 \$ Millions			
1997-8	1998-9	1999-0	2000-01
(\$62)	(\$52)	(\$60)	(\$69)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The revenue impact of this provision would be determined by the number of self-employed individuals who claim additional insurance deductions, and the average marginal tax rate applicable to the deduction amounts.

This estimate was developed in the following steps. First, the number of California resident taxpayers who currently claim the self-employed insurance deduction was calculated from returns filed for 1994 (256,000). Second, the current deduction amount of 25% was calculated to be \$793 for returns filed in 1994, making the average annual health insurance premium \$3172 (\$793 x 4). Third, the estimated number of qualified taxpayers for 1994 was grown at 5% per year to yield 296,000 qualified taxpayers for 1997. Fourth, the insurance premium was grown at 10% per year to yield an average \$4,222 insurance premium for 1997. Fifth, the total amount of deduction at 25% was calculated to be \$313 million for 1997 at a average marginal tax rate of 4.5% (computed by the PIT microsimulation model for self-employed individuals), generating a \$14 million tax loss for 1997 under current law. Sixth, the total amount of deduction was calculated at 100% at a 4.5% marginal tax rate for 1997, generating a \$56 million tax loss. These steps resulted in a 1997 calendar year estimate of an additional \$42 million tax loss. The initial 1997-8 fiscal year estimate above includes all of the 1997 year impact plus 40% of 1998, the latter to reflect reduced estimated tax payments. Losses were grown to reflect a combined annual growth of 5% (qualified taxpayers) and 10% (premiums).

BOARD POSITION

Pending.